nonregulated costs.[26] Accordingly, TWE requests that the Commission revise its service baskets and establish one nonregulated service category.

C. A Permanent Uniform System of Accounts Should Not Be Adopted.

The Commission should not impose a uniform accounting system for cable operators electing cost-of-service regulation. Imposing USOA obligations on all cable operators creates precisely the burdens of public utility regulation proscribed by the Congress.

The Commission's proposal to adopt an intricately detailed, permanent USOA contradicts its own findings that: (1) it has reserved cost-based mechanisms to the "safety net" alternative of cost-of-service regulation; and (2) the cost-of-service rules are a more streamlined approach than Title II regulation.[27] Despite the Cable Act's proscription against regulating cable systems as common carriers, the Commission's proposal to regulate the recording of all financial data by each and every regulated cable system nationwide is a sine qua non of Title II regulation in its purest form.[28] As the Commission acknowledges, a uniform accounting system has "long been

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26 See 47 C.F.R. § 64.901.

27 See Cost-of-Service Order at para. 25.

28 See Kelley and Mercer at 10-11.

recognized as an . . . important component of cost-of-service regulation."[29]

Furthermore, the Commission's belief that "neither GAAP nor the interim summary level accounts will adequately provide, in the long run, for uniform accounting practices"[30] never adequately explains why uniformity beyond GAAP is either necessary or desirable for regulated cable systems. The fundamental justification of the FCC in invoking cost-based regulation is that it is to be used as the exception -- not the rule. Moreover, the proposal is inconsistent with the notion that rate regulation is a transitional measure. The Commission has repeatedly underscored its desire to bring about "effective competition" that will moot the ostensible need for cable rate regulation. The requirement that all regulated systems reorder their books for what is supposed to be an interim period is utterly at odds with the long-term objectives.

D. Use of a Uniform System of Accounts Based on the Telco Model is Inappropriate.

In crafting its USOA proposal, the FCC has lapsed once again back to the familiar but irrelevant: the proposed cable USOA is largely lifted from the USOA for Class B telephone companies. Even if it were lawful, basing a cable USOA system on the telco model is inappropriate. The telco accounts are not transferrable to cable. Simply adding accounts specific to cable

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29 Cost-of-Service Order at para. 220 (footnote omitted).

30 Id. at para. 219.

will not correct the overall problem with using a telco-based system for cable.

From 1935 until 1988, the Commission utilized a USOA which largely mirrored the Interstate Commerce Commission's accounting system. Significant changes in the telephone industry, however, made this USOA unsuitable:

> That USOA was a creature of its times, adapted to the regulatory and industry environment of the regulated monopoly area. Over the last two decades, as technical advances, the growth of competition, the proliferation of new products and services, and changes in industry structure dramatically altered that environment, the old USOA become obsolete.[31]

It took an entire decade, from 1978 to 1988, to reform final telephony accounting rules.[32] This experience demonstrates the enormous amount of time and resources -- literally decades -- it takes to develop a workable accounting system. The makeshift USOA that has been proposed for cable would need to undergo a comparable reconstruction in order to be at all workable -- a timeframe at odds with the limited time in which most cable systems will be under rate regulation.

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[31] Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities, CC Docket No. 86-111, 2 FCC Rcd 1298, 1300 (1987).

[32] Revision of the Uniform System of Accounts and Final Reporting Requirements for Class A and Class B Telephone Companies, 60 Rad. Reg. 2d 1111 (1987).

E. Telco Exemption from Proposed Rules is Unjustified.

Oddly enough, the Notice proposes to exempt telco-provided cable services from the USOA requirements,[33] although the rationale for this proposal is never explained. The fact that the telcos are regulated qua telcos in their provision of telephony tells us nothing about how they might be regulated in their provision of non-telephone services. Surely telcos are not freed of any number of regulations applicable to other businesses simply by virtue of their status as telephone companies. The regulation of telephone companies by the FCC does not somehow permit them to strip mine outside of the environmental protection statutes, to employ workers independent of statutes governing fair labor practices, or to support political campaigns outside the federal election laws. When telephone companies act as cable companies, they become subject to the rules governing cable services. It is indeed ironic that the Commission seeks regulatory parity between telephone services and cable services but not between providers of cable services.

IV. THE COMMISSION SHOULD NOT RESTRICT THE USE OF PREVAILING COMPANY PRICING FOR AFFILIATE TRANSACTIONS

The proposed affiliate transaction rules applicable to cable operators who either elect cost-of-service regulation or seek to adjust benchmark/price cap rates for affiliated programming costs unnecessarily limit the use of prevailing company pricing. These rules are lifted from the proposed rules

[33] Further Notice at para. 308.

pending for telcos and are another example of the Commission importing telco regulation to cable without apparent consideration of the factual context.

The record, to date, does not justify the use of any affiliate transaction rules, given that vertical integration in the cable industry has been driven by market incentives free of regulatory distortions. At most, the interim affiliate transaction rules for cable, permitting actual contract rates to be booked if offered to a "substantial number" of third parties, are more than adequate because fair market tests exist for all substantial transactions to sufficiently guard against manipulative pricing. The record in the cost-of-service proceeding demonstrates that "affiliate transactions in the cable industry primarily involve purchases from affiliated programmers who sell the same products to third parties."[34] Thus, the use of prevailing company pricing is a reasonable, reliable measure of fair market value for the vast majority of transactions that occur between cable affiliates.

By contrast, transactions between telco affiliates often involve assets and services that are unique and highly customized, removing the possibility for market-based tests of their reasonableness. Even where ordinary inputs of a commodity nature are involved, telephone companies have rearranged traditional market transactions in ways that do not readily

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[34] See Cost-of-Service Order at para. 265 (footnote omitted).

permit market tests. Specifically in the telephone company context, the Commission has observed that telcos have created in-house suppliers, and that "these nonregulated affiliates' principal role is to support telecommunications services, either through dealings with affiliated carriers or through transactions with other affiliates that also deal extensively with the carriers."[35] Furthermore, the Commission has questioned whether there was, in fact, any legitimate purpose -- rather than improper cross-subsidization -- for the telcos to purchase assets through affiliates instead of purchasing more cheaply such assets directly from third parties, thus avoiding the transaction costs associated with operating through another entity.[36]

The telco affiliate transaction rules grow out of special recognition of the "faulty incentives" created by traditional rate-of-return regulation.[37] One of the established consequences of traditional telco regulation is an incentive to vertically integrate operations independent of efficiency. A rate-of-return regulated firm will seek to diversify into adjacent markets as a means of misallocating costs to regulated

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[35] Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions between Carriers and Their Nonregulated Affiliates, CC Docket No. 93-251, Notice of Proposed Rulemaking at para. 42, FCC 93-453 (released October 20, 1993) ("Telco Notice").

[36] See New York Telephone Co. v. New England Telephone and Telegraph Co., 5 FCC Rcd 866 (1990) (violations of the Commission's affiliate transaction rules by NYNEX through its wholly-owned affiliate, NYNEX Material Enterprises Co. (MECO)).

[37] Telco Notice at para. 8.

operations (thereby inflating the rate base) and exporting profits to the unregulated operations (in order to manipulate the apparent rate of return earned on the regulated side). Thus, specialized rules were devised to monitor such abuses.[38]

No such history, of course, exists for the cable industry. Vertical integration in the cable industry grew out of efficiency concerns, driven exclusively by market incentives free of regulatory distortions. Most specifically, as the Commission itself has recognized, cable companies have integrated into programming as a means of reducing the risks of launching new services.[39] Vertical integration in the cable industry is thus free of the regulatory considerations which drove the adoption of affiliate transaction rules for telephone companies.[40]

Moreover, the consequences of requiring cost analyses for affiliate transactions in the case of the cable industry are

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[38] Id. at paras. 8-12.

[39] Implementation of Sections 11 and 13 of the Cable Television Consumer Protection and Competition Act of 1992: Horizontal and Vertical Ownership Limits, Cross-Ownership Limitations and Anti-Trafficking Provisions, MM Docket No. 92-264, Notice of Proposed Rulemaking and Notice of Inquiry at para. 45, 8 FCC Rcd 210 (1992).

[40] Indeed, the FCC's concerns with respect to cable affiliated programming transactions have resided in precisely the opposite direction from that for telcos. The FCC has expressed concern in the cable area that prices available from cable programmers to their cable operator affiliates may be preferentially low, rather than artificially high. In the Matter of Implementation of Sections 12 and 19 of the Cable Television Consumer Protection and Competition Act of 1992; Development of Competition and Diversity in Video Programming Distribution and Carriage, MM Docket No. 92-265, First Report and Order at para. 21, 8 FCC Rcd 3359 (1993).

severe. As the Telco Notice details, an intricate and burdensome analysis would be required for cable programmers and other nonregulated suppliers, in essence bringing programming under rate-of-return requirements.

Compliance with the Commission's proposed affiliate transaction rules would impose substantial burdens upon nonregulated businesses, potentially including: (1) reconfiguring accounting systems to reflect what the affiliate originally paid for the equipment and resources used to provide the programming to the regulated affiliate cable operator; (2) developing and implementing some means of ascertaining what portion of those costs are attributable to affiliate transactions; and (3) specifying a rate base methodology, a rate-of-return, and an allowable expense methodology.[41] The Commission has to date correctly eschewed the burdens of regulation on programmers.

The potential regulatory burdens on affiliated programmers are entirely inconsistent with the Commission's policy -- announced just last year -- to create a regulatory environment congenial to the development of programming. In the Rate Regulation Order,[42] the Commission announced it would treat the cost of programming as an exogenous cost that could be passed on to subscribers in order to "assure programmers' continued

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[41] Telco Notice at para. 40.

[42] In the Matter of Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992; Rate Regulation, MM Docket No. 92-266, Report and Order and Further Notice of Proposed Rulemaking, 8 FCC Rcd 5631 (1993).

ability to develop, and cable operators' ability to purchase, programming."[43] In implementing this policy, the Commission perceived a possibility that cable operators might pass through excessive programming costs to subscribers; however, it proceeded to treat programming as an external cost because "[w]e believe . . . that cable operators also have incentives to assure that service rates are not excessive since excessive programming costs, if passed on to subscribers, may cause them to lose subscribers."[44] Thus, the Commission stated that "we attach a greater importance at this initial stage of rate regulation to assuring the continued growth of programming."[45] The relative simplicity of the pass-through would be undermined entirely by the adoption of stringent affiliate transaction rules.

Even assuming that there were legitimate concerns with prevailing company pricing, the 75% "bright line" test is too high. For the largest MSOs in the industry, this threshold is unworkably burdensome. For these MSOs, a large number of programming transactions occur with affiliated entities. The effect on programmers is equally severe. For example, one of the major cable programming suppliers, Turner Broadcasting, is affiliated with several MSOs. If the prevailing company pricing proposal is applied in a cumulative fashion, it will restrict

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[43] Id. at para. 251.

[44] Id.

[45] Id.

TBS's ability to provide programming to these MSOs and will impose extensive regulatory obligations.

No doubt there will be some limited types of affiliate transactions for which the "substantial number" test will not be met. TWE urges the FCC not to impose general rules for accounting for these transactions, but rather require the cable operator to justify challenged rate increases. There is no sound justification for imposing general rules that burden all cable operators and all programmers with cable operator shareholders. Only where subscribers are dissatisfied with a proposed rate increase should a cable operator be required to come forward and explain the basis for such rate changes. These showings should themselves not be limited to cost-based showings, because the reasonableness of affiliate charges could be shown through a variety of other means, including a review of comparable market transactions between non-affiliates as covered by the present rules, or other factors such as transactions with unregulated cable systems, the degree of affiliation,[46] etc.

V. A PRODUCTIVITY OFFSET SHOULD NOT BE APPLIED TO CABLE AS PART OF THE "PRICE CAP" ADJUSTMENT

The price cap mechanism for both benchmark-regulated cable companies and those electing cost-of-service is intended to permit all regulated companies to adjust their rates in accordance with exogenous changes, primarily inflation,

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[46] See e.g., United States v. Western Elec. Co., 1989 U.S. Dist. LEXIS 5250, 1989 U.S. Dist. LEXIS 5225, 1989-1 Trade Cos. (CCH) P 68444, at 12-13 (D.D.C. 1989) (cross-subsidization and discrimination unlikely where telco interest is under 10%).

governmental fees and taxes, and programming costs. The price cap is designed to permit rates to move in accordance with commercial realities and governmental obligations. In the Further Notice, the Commission renews its proposal to offset inflation adjustments with a "productivity offset."

Price cap adjustments were conceptually borrowed from the Commission's regulation of telephony. But beyond the common desire to search for more efficient ways to regulate without eliminating positive incentives for future investment, the comparison becomes useless. The proposal to borrow the productivity offset part of telco price caps has no rational connection to the Commission's statutory mandate to regulate cable rates, and should be dropped once and for all.

A. The Analogy to Telco Productivity Offset is Inapposite.

The concept of a productivity offset for telephone companies grew out of the express recognition that the FCC was moving the telephone industry away from the inefficient distortions worked by rate-of-return regulation to incentive regulation.

The main driving force behind the adoption of a telco productivity offset was the vast amount of quantitative data establishing that the productivity of the telephone industry historically had substantially outpaced the U.S. economy as a whole. The inflation adjustment based solely on GNP-PI, which inherently reflects economy-wide productivity gains, would thus allow telephone companies to increase rates in excess of their true cost experiences. The Commission added a Consumer Productivity Dividend of .5% as another measure to assure that the benefits of price caps would flow to customers in the form of reduced rates. The Commission recognized that absent a productivity offset, telephone company shareholders would become the exclusive beneficiaries of efficiency-producing activity. The FCC believed that the inefficiencies of an operation allowed to develop over the long history of traditional regulation would be eliminated, or at least diminished, under incentive regulation; and, without some additional mechanisms, telco shareholders would be able to reap all of the new profits created by cost-reducing actions taken by telcos. Since it was the telephone monopoly ratepayer who suffered the burden of those inefficiencies through inflated telco costs, the Commission required the benefits flowing from more efficient operations also to be shared with ratepayers.[47] Unlike the record in the telco proceeding, no evidence is presented or even suggested here to warrant the application of a productivity offset.[48]

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[47] Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Notice of Proposed Rulemaking, 2 FCC Rcd 5208, 5218-5219 (1987) ("The purpose of [a productivity offset] would be to pass on to consumers the benefits of anticipated increases in productivity and the resulting reductions in costs . . . ").

[48] As explained in the attached paper, the Commission has implicitly adopted a productivity offset by limiting the inflation offset to changes in the GNP-PI, which reflects economy-wide average productivity increases. See Kelley and Mercer, at 2-3.

B. There is No Record Evidence to Support a Cable Productivity Offset.

It appears that the Commission intends to apply an arbitrary 2% productivity offset unless cable companies demonstrate that some other figure is appropriate.[49] Placing the burden on cable operators to justify a different productivity offset clearly violates the Administrative Procedure Act, which requires that agency decisions be made upon record evidence adduced in the proceeding.[50] Here, no such record exists.

The Commission's proposal to adopt a 2% productivity offset for cable is based on the comments filed by one party, the Staff of the New Jersey Board of Regulatory Commissioners ("New Jersey Staff"). New Jersey Staff stated in its comments that the GNP-PI should be reduced by a "static productivity offset, such as 2% . . . . to reflect the known benefits of technology improvement occurring in the cable industry."[51] The statement is wholly unsubstantiated. It is nothing more than an opinion offered in the record in two sentences.[52]

In the LEC Price Cap proceeding, the record was replete with numerous productivity studies demonstrating telco enjoyment

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49 See Further Notice at para. 320.

50 See 5 U.S.C. § 553(c).

51 New Jersey Staff Comments of the Board of Regulatory Commissioners, MM Docket No. 93-215, at 11, filed August 25, 1993. The apparent basis for the 2% number was the use of that figure for state regulation of telephone companies, and did not involve any inquiry into the cable industry.

52 See Kelley and Mercer at 2-4.

of productivity gains not adequately taken into account by the GNP-PI.[53] Prior to proposing a productivity offset for the telephone industry, the Commission conducted its own long-term and short-term studies and thoroughly reviewed and analyzed two AT&T pre-divestiture studies, two independent studies, and three corroborative findings.[54] The two studies performed by the Commission included a short-term study of productivity for interstate switched access since divestiture and a long-term study of the total telephone industry between 1928 and 1989.[55] By the time the Commission had issued its Second Further Notice of Proposed Rulemaking in that proceeding, it had "amassed a great deal of information about productivity of the telecommunications industry."[56] Describing its record as "exhaustively detail[ed]," the Commission nevertheless sought further comment, study and statistical analysis of the subject before deciding the appropriate productivity offset figure.[57]

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[53] Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Supplemental Notice of Proposed Rulemaking, 5 FCC Rcd 2178, 2211 (1990).

[54] Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Further Notice of Proposed Rulemaking, 3 FCC Rcd 3195, 3401-3408 (1988).

[55] The staff's long-term study indicated that a 2.1% productivity factor would have been appropriate, while the short-term study suggested a 3.5% offset for the industry.

[56] Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Supplemental Notice of Proposed Rulemaking, 5 FCC Rcd 2178, 2217 (1990).

[57] Id. at 2227.

Of course, nothing like that detailed and thorough study has happened here. No party has offered any quantitative analysis. Indeed, no party has even offered a qualitative analysis that would suggest that cable has experienced productivity gains in excess of the gains experienced by the general economy. Moreover, to the extent the FCC has any data on the relative performance of the two industries, it strongly suggests that they are markedly different.[58]

There is sound reason to believe that the factors justifying an offset in telephony are not present in the cable industry. The gains enjoyed in telephony in the last 25 years can be largely attributed to innovations in the computer fields which have driven down the costs of switching equipment while greatly improving their functions and capabilities. The primary costs of cable systems, however, still resides in the actual transmission lines. While the move to fiber obviously improves the performance of the cable system, the mere presence of innovation is not sufficient to establish that cable productivity has outpaced the average of other U.S. industries.

In fact, the deployment of fiber optics may actually increase, not reduce, costs. For example, the operational and maintenance costs associated with fiber optics may be substantially more than that of traditional coaxial cable. Further, the benchmark formula already incorporates any price

[58] See Comments of Continental Cablevision, Inc., MM Docket No. 92-266, Appendix C at 9-11 (filed January 27, 1993).

reductions as a result of productivity gains associated with fiber optics and the corresponding increase in channel capacity. Moreover, unlike telephony, in which technological innovation occurred on an incremental basis, technological improvements in the cable industry have required substantial system upgrades and, in some cases, complete rebuilds. The costs associated with these upgrades are likely to result in increased rates, not reduced rates.[59]

Also, in contrast to the telephone industry, the cable industry is in a constant state of technological change such that it is difficult to predict future productivity trends.[60] This makes it virtually impossible to determine with any confidence the degree of productivity change in the cable industry as a whole.

The Commission has now sought three times to garner record evidence that would justify a productivity offset. None has been forthcoming. The silence is telling.

VI. THE UPGRADE INCENTIVE PLAN AND ABBREVIATED COST-OF-SERVICE SHOWINGS FOR NETWORK UPGRADES SHOULD BE IMPLEMENTED ON A CASE-BY-CASE BASIS

In implicit recognition of the shortcomings of traditional cost-of-service regulation, the FCC has suggested more efficient alternatives, specifically, an upgrade incentive (or social contract) plan as well as a streamlined cost-of-service showing for significant capital improvements. In

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59 See Kelley and Mercer at 7-9.

60 Id. at 6-7.

implementing these programs, the Commission needs to provide more specific inducements to the cable industry in order to allow these alternatives to work. It should eschew industry-wide rules and deliberately allow cable companies the flexibility to proceed on a case-by-case basis.

The interim rules identify two approaches for promoting network improvements. Under the Network Incentive Plan, cable operators would be permitted to enter into "social contracts" with consumers, whereby operators would be given substantial rate flexibility for introducing new regulated services and features. The abbreviated cost-of-service showing for network upgrades allows cable operators to avoid the needless expense of a full-blown cost-of-service hearing to justify rate increases needed to support the costs of necessary and desirable network improvements. These programs could serve to materially ameliorate the disincentives to quality improvements which rate regulation would otherwise create.

As the Commission stated, a properly designed incentive plan for system upgrades should help achieve the important goal of reducing regulatory burdens on cable operators.[61] Industry-wide requirements and rules could impair the efficacy of such programs by trying to make an unworkable "one size fits all" plan that in reality suits no one. Cable companies have vastly different facilities, services, and marketing strategies and requirements. The incentives created to permit such strategies

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[61] See Cost-of-Service Order at para. 153.

to be deployed efficiently must necessarily take account of these wide variations.

In the Second Order on Reconsideration, the Commission noted that investment and innovation depend on two factors: incentives and access to capital.[62] In order to provide both, regulatory burdens cannot be such that they either produce disincentives to invest and innovate, or restrict access to capital. Allowing cable operators to submit individualized proposals explaining how they would implement the Upgrade Incentive Plan allows customization of the programs to suit special needs and thus encourages investment and innovation of new services.

Moreover, in order to achieve national policy goals, most particularly the development of the National Information Infrastructure, the role of franchising authorities must necessarily be limited. The guiding principle for adopting an Upgrade Incentive Plan is to ensure the expansion of capacity and service offerings over cable systems as part of a broader infrastructure. This can only be accomplished through uniform federal guidelines and standards.

The phenomenon of the "prisoner's dilemma" firmly accepted in economic teachings is no stranger to this economic regulatory body. Absent legal constraint, local franchising

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[62] Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, MM Docket No. 92-266, Second Order on Reconsideration, Fourth Report and Order, and Fifth Notice of Proposed Rulemaking at para. 56, FCC 94-38 (released March 30, 1994).

authorities have no incentive to behave responsibly in regulating their local cable companies if they can shift the costs and consequences of such behavior to other jurisdictions. Local franchising authorities may thus seek to impose unrealistic, commercially non-viable prerequisites in defining a qualifying upgrade, or may seek to hold cable operators' rates for upgrades below costs. Over the long term, these incentives will thwart any realistic possibility of implementing the Commission's upgrade programs.

To avoid this consequence, the role of local authorities should be sharply limited to that of implementation. Once a social contract is successfully negotiated between a cable company and the FCC, the franchisor can act to ensure that the scheduled deployment is met in fulfillment of the contract. Similarly, local franchising authorities should have no special role to play in establishing the rate increase necessary to support upgrades under streamlined cost-of-service showings. Just like the FCC's refusal to give automatic party status to local regulators in FCC full cost-of-service hearings, the Commission need not and should not allow a local authority to veto this valuable process. The national telecommunications infrastructure would otherwise be put at risk.

CONCLUSION

The proposals to establish permanent cost-of-service rules for the cable industry are wrong as a matter of law and policy. Especially as applied to benchmark-regulated firms, costing rules defeat any perceived benefits to competitive benchmark regulation. The FCC should displace public utility principles with administratively simpler, efficiency-producing alternatives.

Respectfully submitted,

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TECHNICAL AND ECONOMIC ISSUES IN THE FURTHER NOTICE

Prepared for

Time Warner Entertainment Company, L.P.

Daniel Kelley and Robert Mercer

Hatfield Associates, Inc

July 1, 1994

In a previous paper, we explained why it would be inappropriate to apply the productivity offset developed for local telephone carrier price cap regulation to the cable company benchmark adjustment process.[1] In particular, we demonstrated that the services, architecture, technology, and operations of cable systems and telephone companies differ substantially, making direct application of the telephone company productivity figure to cable companies impossible. We also explained why historical productivity changes in the cable industry are not necessarily a useful guide to future changes. Finally, we showed that the benchmark methodology adopted by the Commission already includes a mechanism for providing consumers with the efficiency gains associated with system growth and expansion.

The Commission has recognized that significant differences between the local telephone and cable industries preclude application of the telephone company price cap productivity offset to the cable industry.[2] Nevertheless, the Commission has tentatively proposed to apply a two percent productivity factor to future cable rate adjustments unless cable companies demonstrate that some other figure is appropriate. In particular, the Commission states that "...cable systems should not expect that their failure to provide any evidence of cable system productivity gains, information they are best able to provide, should justify the conclusion that cable systems cannot reasonably be expected to achieve productivity improvements."[3]

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[1] See Regulatory Parity and Public Policy, September 14, 1993.

[2] See Further Notice of Proposed Rulemaking, CS Docket 94-28, released March 30, 1994, para. 319.

[3] *Id.*, para. 320.

In this paper, we review and extend our previous analysis to show why a Commission requirement that the cable industry provide quantitative evidence of productivity gains is unreasonable. First, we show that there is no basis for a two percent productivity offset. Second, we show again that historical data in the possession of the cable industry can not be used to support a productivity offset. Third, we show that to the extent future productivity trends can be inferred from changes in technology, there is no basis for concluding that there should be an adjustment to benchmark rates. Fourth, we detail the significant public policy detriments that would be associated with application of a productivity offset to the cable industry.

We also address the nature of the regulatory system that the Commission has chosen to apply to the cable industry. We conclude that in many significant respects, the Commission has applied the traditional common carrier regulatory model to the cable industry.

I. THERE IS NO BASIS FOR A TWO PERCENT PRODUCTIVITY OFFSET

The two percent productivity offset proposed by the Commission is based on the statement of the staff of the New Jersey Board of Regulatory Commissioners that there are "...known benefits of technology improvements occurring in the cable industry."[4] There are undoubtedly benefits that flow from technology improvements in the cable industry. But it is incorrect to infer that a productivity offset is justified as a result.

First, by limiting the inflation offset to changes in the GNP-PI, the Commission has already adopted an implicit productivity offset. This is because the GNP-PI reflects economy-

[4] State of New Jersey Board of Regulatory Commissioners, Staff Comments, MM Docket No. 93-215, August 24, 1993, p. 11.

wide average productivity increases.[5] Therefore, the Commission's regulatory scheme includes "known benefits of technology improvements" without adding a separate productivity factor. Only if it could be demonstrated that future productivity increases in the cable industry will exceed this economy-wide average, might it be appropriate to consider a further offset. The reasons why this is not expected to occur are discussed below.

Second, even if there were a reasonable basis to conclude that the productivity increases in the cable industry exceed economy-wide averages, there is no basis for concluding that the benefits flow to regulated service customers. As discussed below, technological change in the cable industry will affect both regulated and unregulated services, including non-video services. Regulated service customers will benefit primarily by the increased quality and reliability of services as well as by having access to new unregulated services. To the extent further investment by cable companies does result in the realization of economies of scale, the benchmark formula is designed to compensate cable customers. However, given that these changes will require substantial expenditures on network upgrades, it is not clear they will cause additional cost reductions for the provision of regulated services. Nor are we aware of any data or analysis that demonstrate additional savings.

Third, even if there were a reasonable basis to conclude that the productivity increases in the cable industry exceed economy-wide averages and that these benefits accrue to regulated service customers, there is no basis to conclude that the offset should be as high as two percent. The New Jersey Board has not offered any empirical basis for the two percent figure cited by the Commission. The two percent productivity factor was suggested evidently because the Board

[5] See "Regulatory Parity and Public Policy," *supra*, note 1, p. 4.

adopted "...such an approach in the context of economic regulation for a local exchange carrier."[6] As our earlier paper demonstrated, there is no basis for attributing telephone company productivity experience to the cable industry, a conclusion with which the Commission evidently agrees.[7] Under these circumstances, using the two percent figure would be arbitrary.

II. HISTORICAL DATA CAN NOT BE USED TO JUSTIFY A PRODUCTIVITY OFFSET

The Commission has asked the cable industry to rebut its proposed two percent productivity figure with evidence that some other number is more appropriate.[8] Great care must be applied to the interpretation of historical productivity data. Much of the historical efficiency gains for the cable industry are due to realizing economies of fill and economies of scale.[9] Cable systems now pass 98 percent of all homes, and serve almost two thirds of the homes passed.[10] As firms grow into their markets, any efficiency increases due to system growth will become harder to sustain.[11]

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[6] See State of New Jersey Board of Regulatory Commissioners, Comments, MM Docket No. 92-266, January 26, 1993, p. 16.

[7] "In the near term, however, the productivity growth that cable operators may reasonably be expected to achieve may differ from that of telephone companies, because of the current differences in their networks, operations, services, and histories." Notice, Para. 319.

[8] Notice, Para. 320.

[9] Economies of fill result from more intensive use of a given system; economies of scale are the result of increasing overall system size.

[10] See National Cable Television Association, Cable Television Developments, November 1993, pp. 1-2A.

[11] Productivity increases in the telephone industry have been large despite the fact that their networks are already well developed. Use of their networks for regulated services has grown rapidly, allowing economies of scale and fill to be realized. As noted above, the major source of future growth in cable will likely be for unregulated services.